North-South-FTAs and the Politics of Discriminatory Liberalization

Mark Manger, PhD
Assistant Professor
Department of Political Science
McGill University
mark.manger@mcgill.ca

Panel D9(b): Trade Liberalization

2008 Meeting of the
Canadian Political Science Association
Vancouver, BC, June 4-6

Introduction

During the past 15 years, the international trade regime has undergone a profound transformation. While in the first decades after the end of World War II, most of global commerce faced only non-discriminatory tariffs, today the majority is covered by preferential rules. In particular free trade agreements (FTAs), accords in which countries liberalize trade among member, but keep their individual, higher tariffs against the outside world, have proliferated rapidly in recent years.

Of these FTAs, again a majority are North-South agreements between developed and developing countries. Moreover, a widely-cited study by Crawford and Fiorentino[1] finds that of the large number of trade agreements under negotiation, North-South-FTAs are the fastest-growing type, a striking development when considering that the first FTA between a developed and developing country only came into force in 1994—the North American Free Trade Agreement.

The rapid proliferation of FTAs in general has raised concerns about the loss of access to export markets, as more and more countries grant preferential terms to each other. Yet the alleged discriminatory effect and its manifestation in the diversion of trade—in the sense of privileging producers within the FTA over those outside—is difficult to substantiate even for ardent critics of discriminatory rules.[2] Especially in the case of North-South-FTAs, the pursuit of trade liberalization in partnership with a bigger, more developed partner has often been part of broader reform economic reform efforts, in particular in Latin America,[3] that led to the reduction of most-favored-nation tariffs (the duties applied in a non-discriminatory fashion to everyone) as well as preferential tariffs, even if not to the same extent, greatly reducing the potential for trade diversion.

More puzzlingly, for high-income countries, especially major economic powers like the United States, Japan and the European Union, the small export markets of developing countries are of limited economic importance compared to the relations with other developed countries. Simulation studies generally find only minuscule benefits for developed countries. The US-Colombia FTA is expected to bring about a GDP increase in the United States in the order of 0.000047 percent, equal to a one-time increase in the income of each US citizen by slightly more than one penny.[4] A recent study of the prospects of an EU-ASEAN FTA predicts production growth in the order of 0.4 percent in some sectors in the EU, but sizable reductions of 2-4 percent in other, less competitive European industries like leather and apparel.[5] The small benefits are unsurprising, given that even Indonesia, the biggest country in ASEAN, only buys 0.43 percent of EU exports.[6] Yet this has not stopped the Commission from outlining a bold plan

[1] Jo-Ann Crawford and Roberto V. Fiorentino, "The Changing Landscape of Regional Trade Agreements," in *Discussion Paper* (Geneva: WTO Secretariat, 2005).
[2] Anne O. Krueger, "Trade Creation and Trade Diversion under Nafta," (Cambridge, MA: National Bureau of Economic Research, 1999).
[3] Maxwell A. Cameron, "North American Trade Negotiations: Liberalization Games between Asymmetric Players," *European Journal of International Relations* 3, no. 1 (1997).
[4] Clara Patricia Martín and Juan Mauricio Ramírez, "Impacto Económico De Un Acuerdo Parcial De Libre Comercio Entre Colombia Y Los Estados Unidos," in *Estudios y Perspectivas* (Bogotá: Oficina de la CEPAL en Bogotá, 2005).
[5] Houssein Boumellassa, Yvan Decreux, and Lionel Fontagné, "Economic Impact of a Potential Free Trade Agreement (Fta) between the European Union and Asean," in *Report to the Commission of the European Union, Directorate General for Trade* (Paris: CEPII-CIREM, 2006).
[6] According to EU Commission statistics, http://trade.ec.europa.eu/doclib/html/112008.htm.

for the negotiation of numerous FTAs with emerging economies.[7] How can these two realities be squared? Why do Japan, the EU, the United States and Canada invest significant resources in negotiating FTAs with much smaller economic partners?

The answer, this paper submits, does not lie in the effect of FTAs on traditional exports. Rather, the spread of North-South-FTAs reflects the growing importance of foreign direct investment (FDI) in the international economy. FDI flowing from developed to liberalizing developing countries changes the incentives for states to pursue preferential options: FTAs allow firms to make efficiency gains while raising the costs of entry for outsiders. In North-South-FTAs, multinational firms frequently seek to raise barriers for firms from third parties through high rules-of-origin and other tariff and non-tariff measures.[8]

Free trade agreements therefore create an endogenous dynamic: fearing for the competitive position of their firms, other countries conclude "defensive" bilateral agreements. The driving force is not the concern over the loss of markets for traditional exports, but the preferential terms on which firms from FTA partners can trade the goods crucial for profitable investments—parts, capital goods, and the products these multinational firms produce—and the barriers these FTAs erect against outsiders.

North-South-FTAs: Stylized Facts

Preferential trade agreements come in three different legal forms: partial scope agreements, customs unions, and free trade agreements. When a WTO member enters into a preferential trade agreement to grant more favourable conditions to specific trade partners than to other WTO Members, it departs from the guiding principles of non-discrimination. Those principles are generally defined in Article I of the General Agreement on Tariffs and Trade (GATT) and Article II of the General Agreement on Trade in Services (GATS).[9] However, WTO Members are permitted to enter into such arrangements under specific conditions which vary depending on the level of integration sought. All have to comply (at least in theory) with Art. 24 of the GATT, optionally the Enabling Clause in the case of agreements between developing countries, and Art. 5 of the GATS in the case of services agreements.

Partial scope agreements are designed, as the name suggests, to liberalize only part of the trade between the partner countries, and as such are generally negotiated by developing countries

---

[7] Commission of the European Communities, "Global Europe: Competing in the World," (Brussels: Commission of the European Communities, 2006).

[8] Kerry A. Chase, "Economic Interests and Regional Trading Arrangements: The Case of Nafta," *International Organization* 57, no. 1 (2003), Antoni Estevadeordal and Kati Suominen, "Rules of Origin: A World Map" (paper presented at the Pacific Economic Cooperation Council (PECC) and the Latin America/Caribbean and Asia/Pacific Economic and Business Association (LAEBA) Seminar on "Regional Trade Agreements in Comparative Perspective: Latin America and the Caribbean and Asia-Pacific", Washington, DC, 22-23 April 2003), Jeri Jensen-Moran, "Choice at the Crossroads: Regionalism and Rules of Origin," *Law and Policy in International Business* 27, no. 4 (1996), Kala Krishna and Anne O. Krueger, "Implementing Free Trade Areas: Rules of Origin and Hidden Protection," in *New Directions in Trade Theory*, ed. Alan Deardorff, James Levinsohn, and Robert Stern (Ann Arbor: University of Michigan Press, 1995), Anne O. Krueger, "Are Preferential Trading Arrangements Trade-Liberalizing or Protectionist?," *Journal of Economic Perspectives* 13, no. 4 (1999), Anne O. Krueger, "Free Trade Agreements as Protectionist Devices: Rules of Origin," in *NBER Working Paper* (Cambridge, MA: NBER, 1993).

[9] Article I of the GATT states that members "shall unconditionally offer to all other contracting parties (members) any advantage, favour, privilege or immunity affecting customs duties, charges, rules and procedures that they give to products originating in or destined for any other country."

only, who by virtue of the Enabling Clause,[10] can postpone the further reduction of trade barriers (almost) indefinitely. By contrast, Art. 24 prescribes the liberalization of "substantially all trade" between members to an agreement without erecting "on the whole higher" trade barriers to non-members. The imprecise language of Art. 24 allows for a wide range of interpretations, in particular in the exclusion of sectors. For example, whether two countries eliminate *substantially all tariffs* or *the tariffs on substantially all current trade* is much more than a verbal nuance: the former leads to almost complete liberalization, while the latter may preserve precisely the most prohibitive tariffs that are high enough to prevent all trade of the goods in question. For WTO members, these articles open the only permissible ways to extend tariff preferences to a specific partner without unconditionally extending them to all other members. This institutional constraint is crucial for FTAs to have discriminatory effects. In its absence, a country that has just concluded a trade agreement with one country could selectively extend benefits to a third country to avoid hurting its relations with that party. Art. I of the GATT prohibits such selective benefits and forces states to choose between the stark alternatives of non-discriminatory and preferential trade.

A second important distinction must be made between customs unions and free trade agreements. In customs unions, members commit to a common external tariff. FTAs, in contrast, allow members to set their own most-favored-nation tariffs. Customs unions are more difficult to negotiate, since domestic industries in the member countries may have different preferences. For example, while the United States levies a 25 percent tariff[11] on heavy trucks, Canada, with hardly any national production, only charges a 3 percent duty. Finding a compromise between such divergent positions is politically challenging compared to the easy path of an FTA.

Unfortunately, the different external tariffs in FTAs require complex rules to avoid transshipment.[12] In the above example, in the absence of rules to the contrary, trucks would be imported into Canada, paying only the lower tariffs, and then sold on into the US without paying any further duties, thanks to the tariff-free provisions under NAFTA. Hence the need for rules of origin (ROOs), complex regulations that determine what percentage of a good has to be sourced within the FTA, what "transformation" a good has to undergo, or how much value has to be added for a good to qualify for tariff-free shipping within the free trade area. However, such rules of origin can also be used to introduce a good dose of protection into an agreement that is supposed to free trade. Naturally, US truck manufacturers that benefit from the 25 percent tariff would also be worried about the possibility of foreign assembly in Canada. Hence they would be likely to lobby for high minimum North American content in the product—a high threshold of North American parts in the trucks—to qualify for tariff-free shipping, as the experience of the NAFTA negotiations has indeed shown. FTAs can be tailored to significantly reduce the adjustment that trade liberalization normally requires.

It is unsurprising, then, that today almost 99 percent of new preferential trade agreements are of the FTA-type. The few customs unions in existence are among geographically contiguous

[10] A product of the 1979 Tokyo Round of the GATT. See generally Calvert D. A. (2002), "How the Multilateral Trade System under the World Trade Organization is Attempting to Reconcile the Contradictions and Hurdles Posed by Regional Trade Agreements: An Analysis of Article XXIV of the General Agreement on Tariffs and Trade," http://www.cid.harvard.edu/cidtrade/Papers/calvert.pdf.

[11] This tariff is know as the "chicken tax" since it originated in a trade war between the EC and the US in 1963, when the European side tripled the tax on imported chicken and the US retaliated with a tax on trucks. It has since ossified into a privilege that no administration has been able to abolish.

[12] Kerry A. Chase, "Protecting Free Trade: The Political Economy of Rules of Origin," *International Organization* 62, no. 3 (forthcoming).

countries, most notably the European Union and Mercosur. Close to 80 percent of FTAs in force and nearly all newly negotiated and proposed agreements are bilateral in nature. Moreover, cross-regional agreements with at times quite distant partners (e.g. Chile-South Korea) make up the majority of FTAs negotiated since 2000. Finally, agreements between a developed and (at least one) developing or transition country partner constituted a third of all agreements notified to the WTO by late 2006 and over half of all newly proposed FTAs.[13]

Less appreciated but all the more puzzling is the pattern of many North-South-FTAs. Often, one agreement between a developed and a developing country partner is followed by FTAs of other developed countries with *the same* southern partner. NAFTA preceded the EU-Mexico and Japan-Mexico agreements. The EU-Chile and US-Chile agreements were concluded within the time frame of two years, followed by the Japan-Chile-FTA a few years later. Japan has signed FTAs with Singapore, Thailand and Malaysia. The US has already concluded an FTA with Singapore and is negotiating with the other two ASEAN countries. Not to be outdone, the EU has announced the opening of negotiations with the ASEAN countries, although progress is hampered by the EU's commitment to a "democracy clause"[14] and the support that fellow ASEAN members offer to the authoritarian regime in Burma (Myanmar). This pattern is hard to explain with the existing theoretical apparatus.

Driving Forces of Preferential Trade

Political economists either locate the driving forces of regionalism at the international or systemic level or focus on the domestic sources of trade policy. Among explanations at the international level, recent arguments increasingly point to the role of the WTO. Mansfield and Reinhardt[15] argue that the growth of WTO membership, the recurrent negotiation rounds and in particular the participation in trade disputes motivate states to seek PTAs as an insurance policy: Should WTO rounds fail or end up deadlocked, states still gain market access and increase their market power. Likewise, PTAs can serve as coalition-building strategy to increase bargaining power or to "obtain countervailing market access"[16] in case of losses in WTO disputes. In a sense, the multilateral trade regime has become the victim of its own success. Their findings also suggest that countries are concerned about the potential loss of access to markets—although the level of aggregation of the study does not allow for a more detailed investigation—and that longer multilateral negotiating rounds are likely to lead countries to seek preferential alternatives. These findings resonate with the statements of both public[17] and scholars[18] in recent years.

---

[13] Roberto V. Fiorentino, Luis Verdeja, and Christelle Toqueboeuf, "The Changing Landscape of Regional Trade Agreements: 2006 Update," in *Discussion Paper* (Geneva: WTO Secretariat, Regional Trade Agreements Section, Trade Policies Review Division, 2006), 6.
[14] See Marcela Szymanski and Michael E. Smith, "Coherence and Conditionality in European Foreign Policy: Negotiating the Eu-Mexico Global Agreements," *Journal of Common Market Studies* 43, no. 1 (2005). for a detailed analysis of EU conditionality in trade agreements.
[15] Edward D. Mansfield and Eric Reinhardt, "Multilateral Determinants of Regionalism: The Effects of Gatt/Wto on the Formation of Preferential Trading Arrangements," *International Organization* 57, no. 4 (2003).
[16] Ibid., 830.
[17] Financial Times, 19 November 2002.
[18] Raquel Fernández and Jonathan Portes, "Returns to Regionalism: An Analysis of Nontraditional Gains from Regional Trade Agreements," *World Bank Economic Review* 12, no. 2 (1998). Paul R Krugman, "Regionalism Versus Multilateralism: Analytical Notes," in *New Dimensions in Regional Integration*, ed. Jaime De Melo and Arvind Panagariya (Cambridge, UK: Cambridge University Press, 1993), 74.

Other authors have argued that since free trade agreements are easier to negotiate than a complex multilateral undertaking, they allow countries to move to free trade at a faster pace. Unfortunately, the excluded sectors seem to be the same in preferential and multilateral negotiations: Agriculture has always been the biggest stumbling block in multilateral negotiations, but proved to be immensely difficult to liberalize in the Japanese FTA initiatives as well.[19] The US-Australia FTA avoided liberalization of the US sugar market, one of central stumbling blocks at the failed WTO meeting in Cancún. While the problems of the WTO provide a general impetus for states to sign FTAs, we are still left without an explanation for the choice of partners in North-South-FTAs.

As Haggard reminds us in an early analysis of the recent wave of regionalism, whether two countries decide to form a trade agreement primarily depends on the convergence or divergence of interests.[20] An important reason for developing countries to seek out FTAs with more developed partners has been to bolster reform processes. One key element is the attempt to prevent future governments from reversing an economic opening. The more developed partner's role is to impose and enforce liberalization measures that the government would not have been able to pursue on its own against domestic resistance.[21] Evidence of such a strategic use of FTAs for domestic purposes has been brought forth in the case of Mexico.[22] The primary reward comes in the form of foreign direct investment, as potential investors are reassured of the stability of the policy environment.[23] Hence for developing countries, the risk of FDI diversion posed by FTAs may be as important as the possible loss of export markets. FTAs may also be sought proactively by developing countries, for example by ASEAN governments that might fear the diversion of FDI to China.[24]

While there are numerous reasons for developing countries to conclude FTAs with more developed partners, it is less clear why major economic powers would take up these offers, given the small market sizes their potential partners can bring to the table. Since developed countries are not particularly eager to open their markets for the products that offer the greatest gains because of the comparative advantage of many developing countries—agricultural exports—the economic rationale must lie elsewhere.

Recent research at the domestic level focuses on the interests of multinational firms. Chase argues that firms seek to achieve economies of scale in an FTA by restructuring and

---

[19] Aurelia George Mulgan, "Where Tradition Meets Change: Japan's Agricultural Politics in Transition," *Journal of Japanese Studies* 31, no. 2 (2005).
[20] Stephan Haggard, "Regionalism in Asia and the Americas," in *The Political Economy of Regionalism*, ed. Edward D. Mansfield and Helen V. Milner (New York: Columbia University Press, 1997).
[21] Fernández and Portes, "Returns to Regionalism: An Analysis of Nontraditional Gains from Regional Trade Agreements.", Kenneth C. Shadlen, "Exchanging Development for Market Access? Deep Integration and Industrial Policy under Multilateral and Regional-Bilateral Trade Agreements," *Review of International Political Economy* 12, no. 5 (2005).
[22] Maxwell A. Cameron and Brian W. Tomlin, *The Making of Nafta: How the Deal Was Done* (Ithaca, NY: Cornell University Press, 2000), Manuel Pastor and Carol Wise, "The Origins and Sustainability of Mexico Free-Trade Policy," *International Organization* 48, no. 3 (1994).
[23] Tim Büthe and Helen V. Milner, "The Politics of Foreign Direct Investment into Developing Countries: Increasing Fdi through Policy Commitment Via Trade Agreements and Investment Treaties" (paper presented at the Annual Meeting of the American Political Science Association, Chicago, IL, 2-5 September 2004), Francesca Di Mauro, "The Impact of Economic Integration on Fdi and Exports: A Gravity Approach," (Brussels: Centre for European Policy Studies, 2000), Eduardo Levy Yeyati, Ernesto H. Stein, and Christian Daude, "Regional Integration and the Location of Fdi," (Washington, DC: IADB, 2003).
[24] Razeen Sally, "Thai Trade Policy: From Non-Discriminatory Liberalisation to Ftas," *The World Economy* 30, no. 10 (2007).

specializing transplant factories built under more protectionist developing host country policy,[25] a thesis that has been corroborated in case studies of agreements in Asia.[26] Multinational firms can make efficiency gains by moving labor-intensive production stages to an FTA partner country with lower wage cost.[27] Accordingly, the interests of developed and developing countries tend to converge on foreign direct investment, in particular the shift of manufacturing industries from high- to middle-income countries during the past decade. FTAs facilitate this movement by guaranteeing a stable business environment, by lowering tariffs for the goods that multinational firms want to ship back and forth, and by establishing a broad legal framework for investment.

As Katada and Solís have argued in a path-breaking paper,[28] governments will therefore see the need to strategically use FTAs to advance their interests in the political, legal, and economic domain. Countries will seek FTAs to protect access to export markets, define and redefine political relations, and to define and disseminate standards for FDI, competition policy, and labor and the environment in the hope that these will later become the rule at the WTO.[29]

The economic incentives for multinational firms to support North-South integration outlined by Chase suggest that FTAs will become even more popular. Likewise, the desire to promote preferred standards may count among the most important driving forces of North-South-FTAs. However, neither argument helps us to explain why major economic powers would try to "catch up" with competitors by likewise signing an agreement with the developing country, leading to the conspicuous pattern of FTAs with the same preferred partners. For example, to the extent that Southeast Asian countries are adopting Japanese regulations upon concluding an FTA with their northern partner, the US and the EU will not be able to foist their own standards upon these countries if they negotiate FTAs with them at a later date. Hence being a first-mover may have an advantage, but in terms of standards, the playing field is not easily leveled.[30] The outsourcing of labor-intensive stages of production to a geographically proximate partner explains why Japan had an interest in an FTA with Thailand, but not why the US and the EU would follow this lead. Finally, the hypothesized trade diversion has not, to date, been substantiated empirically. To explain the competitive dynamic of FTAs, this paper argues, we need to focus our attention on the role of FDI. The next section outlines this framework.

Preferential Agreements and Multinational Firms

One of the most pronounced effects of the liberalization in emerging markets is a drastic increase in the flows of FDI, both in services and in manufacturing. Firms engaging in FDI in these sectors support PTAs because of the competitive benefits they entail for them.

[25] Chase, "Economic Interests and Regional Trading Arrangements," 143-145..
[26] Hidetaka Yoshimatsu, "Preferences, Interests, and Regional Integration: The Development of the Asean Industrial Cooperation Arrangement," *Review of International Political Economy* 9, no. 1 (2002)..
[27] Chase, "Economic Interests and Regional Trading Arrangements," 145-146.
[28] Mireya Solís and Saori N. Katada, "Competitive Regionalism: Strategic Dynamics of Fta Negotiation in Japanese Trade Diplomacy," in *Annual Convention of the International Studies Association* (Chicago, IL: 2007).
[29] Ibid.
[30] The argument may, however, have much greater bearing on services FTAs where standards and regulations play a key role.

Take the following stylized situation of three countries, two advanced, developed countries A_1 and A_2, and D, a liberalizing developing country. To simplify, country D imposes a uniform MFN tariff of 15 percent; countries A_1 and A_2 levy a 5 percent uniform tariff. Wages are lower in D than in A_1 and A_2, making it an attractive location for manufacturing investment for export. But as a liberalizing country with a bright future, it also promises to be a growing market in its own right. Consequently, D attracts FDI in manufacturing and services from A_1 and A_2. Figure 1 depicts this situation.

In this case all multinational firms pay D's MFN tariff on intermediate goods, as do all upstream producers. If firms want to use the location-specific benefits of investing in D, they would therefore support the reduction of barriers, expressed in proposition I:

I. *The more FDI in a sector from A_1 to D, the more multinational likely firms in that sector are to support free trade.*

To reduce their burden, A_1's firms could just lobby for unilateral or multilateral reduction in the MFN tariff of the home and host country, something that multinational firms regularly do.[31] But then firms from A_2 could use D as an export platform and threaten the home market of A_1. A preferential trade agreement therefore serves A_1 's firms' needs better. With sufficiently tight rules of origin, A_1 secures exclusivity.

As described above, rules of origin are meant to prevent transshipment, that is the import of a good into the country with the lower tariffs and the subsequent shipping into the PTA member with the higher tariff, that is from A_1 to D. In practice, however, rules of origin are often used to shut out competitors from the developing country.

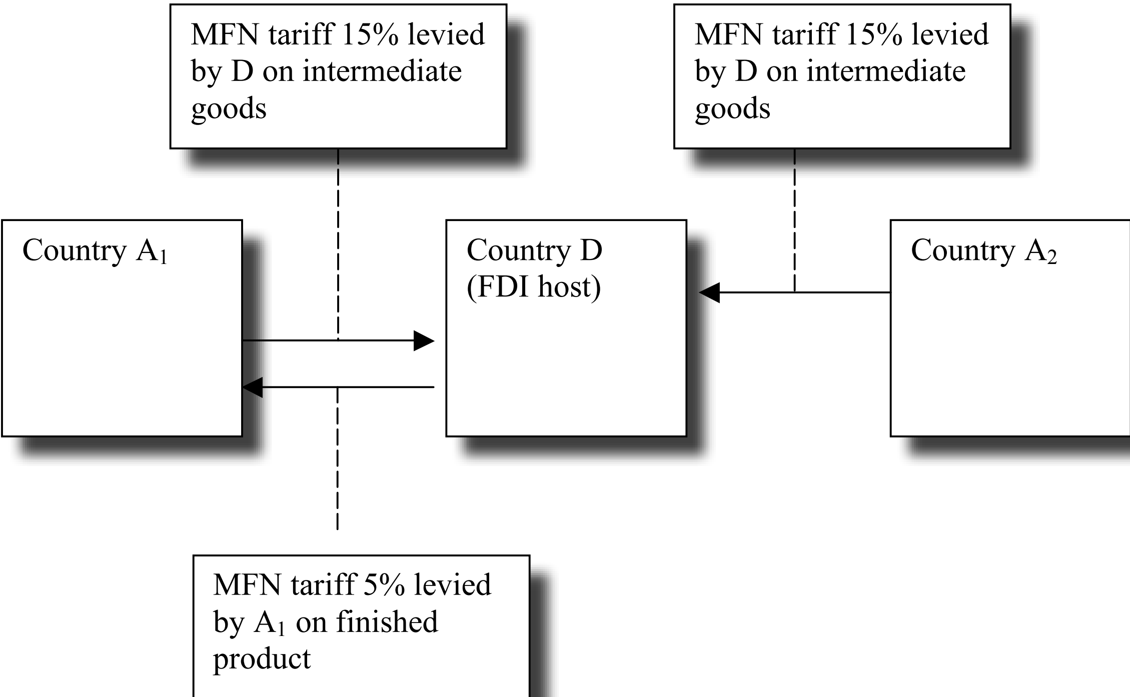

Figure 0: Tariff barriers prior to an FTA

Investor firms from A_2 are now at a severe disadvantage: they pay the MFN tariff of country D for intermediate goods, plus the MFN tariff of A_1 if they export there, but fail to meet

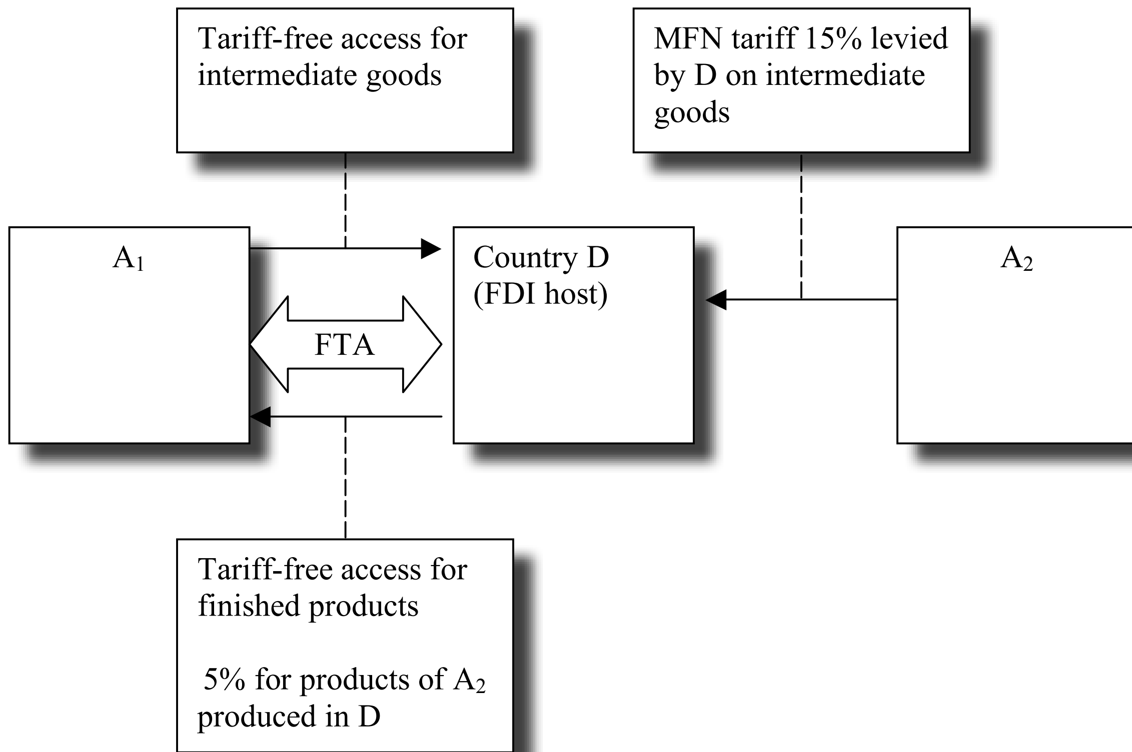

Figure 0: Tariffs with an FTA

the rule of origin requirement. Even when D is more than just an export platform its previous unilateral liberalization makes the old-style, tariff-jumping production infeasible: A_2's firms will need to serve more than just the original, potentially even the whole PTA market to be efficient, because they compete with A_1's preferential access. This leads to proposition II:

II. The more investment from A_2 in D, the more likely are firms from A_1 to demand high rules of origin.

This scenario is depicted in Figure 2.

[31] Helen V. Milner, *Resisting Protectionism: Global Industries and the Politics of International Trade* (Princeton, NJ: Princeton University Press, 1988), 26-29.

In this case, the costs are different:

Table 1: Preferential Tariffs and Export Platforms

	For sales in D	For sales in A_1
Firms from A_2	15 percent MFN tariff levied by D on parts imports	15 percent MFN tariff levied by D on intermediate goods 5 percent MFN tariff levied by A_1 unless rule of origin is met
Upstream producers from A_2	15 percent MFN tariff	--
Firms from country A_1	Zero tariff	Zero tariff
Upstream producers from A_1	Zero tariff	Zero tariff

Firms from country A_2 thus face a dilemma: Either produce below efficient scales of production and thus lose out against competition from A_1, face a higher tariff burden than the competition from A_1, or source more parts and machinery from within the PTA, even if this entails higher costs.

Usually, firms will therefore seek tariff relief. In principle this could be achieved either by lobbying the host government of country D to reduce its tariffs unilaterally. However, the GATT imposes a clear legal constraint on preferential tariff relief: it can only be granted in a regional trade agreement in accordance with Art. 24. The only alternative for D to prevent the rules of origin in its first FTA from becoming a barrier to outsiders is then to eliminate its MFN tariffs. But if that were feasible in D's domestic political arena, the country would not need an FTA with a developed partner in the first place. We might still see firms from A_2 try to lobby for selective reductions of MFN tariffs, but such attempts are unlikely be successful.

Proposition III follows:

II. *If A_1 and D conclude a FTA, the more FDI from A_2 in D, the more likely the firms engaged in such FDI will seek a "reactive" FTA.*

The case is much simpler for exporters from A_2 to D: if they face competition from A_1 in D's market, they will support an FTA between A_2 and D as well. The producers of the intermediate goods that A_1's firms import, fearing to lose their clients if these deinvest, further broaden this coalition. Multinational firms from A_1 will therefore mobilize their "rent chain"[32] of suppliers and upstream producers to help their lobbying efforts.

Note that the same logic holds for investment liberalization. Assume D limits foreign investment in its industries. Since firms from A_2 cannot expand the local base of suppliers by asking their home country partners to invest, they are at a further disadvantage. If services are included in the FTA, then the discriminatory effects are even more pronounced. A first-mover can structure the market in a way that raises rivals' cost of market entry by buying up the relevant assets (for example in the case of privatization) and establishing a distribution network.

The above discussion shows why FDI makes firms more sensitive to the costs and benefits of preferential trade liberalization, leading to greater pressure on governments to pursue FTAs. Since each FTA has the potential to cause counter-FTAs with the host country, a

[32] David P. Baron, "Integrated Market and Nonmarket Strategies in Client and Interest Group Politics," *Business and Politics* 1, no. 1 (1999).

competitive dynamic unfolds. Government officials charged with trade policy respond to this dynamic because of lobbying by multinational firms. The longer a home country government stays on the sidelines, the higher the costs born by its multinational firms. Consequently, home country governments get pushed into signing more and more bilateral deals, some pre-emptively, some in defense against existing FTAs. The discriminatory effect of FTAs on FDI thus endogenously spurs on the proliferation of more agreements. Major economic powers pursue FTAs with emerging markets to protect the competitiveness of their multinational firms. But the narrow set of interests limited to multinational firms and their suppliers also underlines the private goods character of these efforts.

In the following, I test this explanation in three case studies: the North American Free Trade Agreement (NAFTA) and the two defensive agreements Japan and the EU signed with Mexico. The lag between the entry into force of the three agreements (1994, 2000, and 2005) and the diversity of firms active in Mexico allow for detailed process-tracing[33] to analyze the causal chain. While the logic of endogenous causation rules out standard controlled comparison,[34] explicit modeling of the causal sequence offers a solution.[35] As argued by Büthe, sequence "(…) allows us to have causal feedback loops from the *explanandum* at one point in time to the explanatory variables at a *later* point in time only."[36] In addition, I disaggregate the cases[37] to the level of industries to gain additional explanatory leverage.

Qualitative data for the study is collected through the analysis of interest group publications, documented lobbying activity such as congressional hearings, and interviews with decision-makers in government and industry. Given different political systems, such data cannot be truly "symmetric"[38] in the sense that a uniform method of collecting information is used in all cases: lobbying in Japan leaves no visible paper trail, while evidence of comparable activities in the US is often publicly available. However, this problem is less acute when using narratives as evidence than in large-*N* statistical research.

NAFTA: Mexico As One Big Maquiladora?

NAFTA represented a major step in the proliferation of regional trade agreements in the 1990s. While the creation of the European Common Market in 1992 is often seen as the tipping point for regionalism, NAFTA stands for a new trend: the conclusion of bilateral agreements between developed and developing countries. The creation of the EU itself linked countries of similar levels of development, although its eastern expansion to include transition countries may well have effects similar to NAFTA.[39] In particular, while the EU actually traded more with the

---

[33] Gary King, Robert O. Keohane, and Sidney Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research* (Princeton, NJ: Princeton University Press, 1994), 85-87., 225-28.
[34] Alexander L. George, "Case Studies and Theory Development: The Method of Structured, Focused Comparison," in *Diplomacy: New Approaches in History, Theory, and Policy*, ed. Paul Gordon Lauren (New York: Free Press, 1979), Alexander L. George and Timothy J. McKeown, "Case Studies and Theories of Organizational Decision Making," *Advances in Information Processing in Organizations* 2 (1985).
[35] Tim Büthe, "Taking Temporality Seriously: Modeling History and the Use of Narratives as Evidence," *American Political Science Review* 96, no. 3 (2002).
[36] Ibid., 485, emphasis in the original.
[37] King, Keohane, and Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research*, 220-221.
[38] Ibid., 48.
[39] The most recent bilateral initiatives of the EU clearly point in this direction. As of 2008, the EU only trades with six countries - Australia, Canada, Japan, New Zealand, Taiwan, United States - on MFN basis.

outside world after 1992, albeit from a higher base, the NAFTA countries share of intra-regional exports jumped from 42 to 56 percent between 1991 and 2000.[40]

As second misperception is that NAFTA brought about major changes in Mexican trade policy that triggered massive flows of direct investment. But as Graham and Wada have shown, "investment into Mexico began to accelerate following the onset of reform in the late 1980s (well in advance of NAFTA) and has grown at pretty much unabated rates ever since."[41] NAFTA represent the culmination of almost a decade of economic reforms in Mexico. The central factor in the investment decisions of US firms, these reforms and the resulting prospects for US firms determined their stance towards an FTA. In particular, they led firms with interests in FDI in Mexico to support NAFTA and to try to influence its final form.

Following Mexico's rapid liberalization efforts in the second half of the 1980s, US auto manufacturers were the most important investors by totally committed capital. US automakers' new plants included the Ford site in Hermosillo that broke efficiency records for the American continent. These new plants reflected current technological standards and were located, tellingly, near Mexico's northern border and away from the outdated plants near Mexico City.[42] The restructuring and modernization of the Mexican auto industry brought about the successful reintegration into global markets: by 1992, automotive products (parts and assembled cars) represented 16 percent of all Mexican exports to OECD countries, with close to 80 percent shipments to the US. In search of a low-cost production site for small cars to counter the market share gains of Japanese manufacturers, the Big Three turned to Mexico. For Mexico's government, foreign direct investment served as a restructuring agent to regain competitiveness.[43]

The example of the auto industry is reflected elsewhere. Research into corporate strategies has shown that in the electronics and household appliances industries, the integration of Mexico into a North American production network already picked up speed in the late 1980s. The primary aims were to increase market share in Mexico, increase the volume of Mexican operations to achieve economies of scale, and to integrate Mexican operations into the US network to gain efficiency in R&D and marketing.[44]

Much of the integration took place through the growth in *maquiladora* (in-bond) factories. Unlike the rest of the Mexican economy, the *maquiladora* sector was open to 100 percent foreign ownership, provided that 80 percent of the production was exported. In addition, imported inputs for the *maquila's* production were exempted from duty if used for exports.[45] Under US tariff classifications 806 and 807, products could be exported to Mexico, processed, and re-imported into the US. Duty was only levied on the value added abroad. The *maquiladoras* attracted

---

[40] Financial Times, 19 November 2002.

[41] Edward M. Graham and Erika Wada, "Domestic Reform, Trade and Investment Liberalisation, Financial Crisis, and Foreign Direct Investment into Mexico," *World Economy* 23, no. 6 (2000): 779.

[42] Juan C. Moreno Brid, "Mexico's Auto Industry after Nafta: A Successful Experience in Restructuring?," in *Working Paper* (Notre Dame, IN: Kellogg Institute of International Studies, University of Notre Dame, 1996).

[43] Stephen Blank and Jerry Haar, *Making Nafta Work: U.S. Firms and the New North American Business Environment* (Miami, FL: North-South Center Press, 1998), 66-68, T. Ozawa, "The Southerly Spread of America's Automobile Industry. Flexible Production and Foreign Direct Investment as a Corporate Restructuring Agent," *World Competition* 17, no. 4 (1994).

[44] Blank and Haar, *Making Nafta Work: U.S. Firms and the New North American Business Environment*, 34.

[45] United States International Trade Commission, *The Likely Impact on the United States of a Free Trade Agreement with Mexico*, *Usitc Publication ; 2353* (Washington, DC: United States International Trade Commission, 1991), 1-5.

considerable investment from US firms, but also from Japanese and European multinationals that used their US subsidiary.

At the same time, Mexico's liberalization presented an opportunity for multinationals from Japan and Europe to produce close to the US market. The US imposed only low MFN tariffs of less than 4 percent on most Mexican imports---and even less in the case of *maquiladora* products. In addition to the low wages in Mexico, limited transport costs to the US and in particular in the case of Japanese manufacturers, avoiding bilateral pressures and "voluntary" export restrains, made Mexico a highly attractive location. Importantly, Mexico granted these firms full exemption from MFN tariffs on their imported parts from Japan and elsewhere, provided the final product was exported again.

Much of the appeal of NAFTA therefore lay in the ability of US firms to use a regional trade agreement to raise the barriers for outsiders. Consequently, much of the lobbying effort around NAFTA was made not to just ensure the conclusion of the agreement, but to shape its provision to provide maximum protection for US firms in Mexico. NAFTA's rules of origin are the most obviously protectionist in the automotive sector, where the Big Three demanded a higher threshold than in the Canada-US FTA. Targeting Japanese manufacturers, they sought to avoid a repetition of problems like Honda's production of Civic models in Ontario that sold well in the US market.[46] Ford and Chrysler thus demanded a rule of origin threshold of up to 70 percent, while GM settled for 60 percent,[47] since it had a joint venture with Isuzu in Canada that benefited from imported parts.[48] Strong support came from both labour and parts producers organized in the Motor and Equipment Manufacturers Association (MEMA), who sought the highest threshold.[49] The final outcome in the negotiations was a 62.5 percent rule, a compromise between the US, Mexican and in particular Canadian negotiators who had sought a lower level. In addition to the restrictive rules, the US Big Three attained a two-tiered phase-out period of the remaining Mexican host country measures---faster for incumbents than for new entrants. In particular, firms that had existing operations in Mexico (the Big Three, Volkswagen and Nissan) were allowed to produce vehicles with a lower domestic content that new operations by competitors.[50] Specifically, incumbents did not have to satisfy the 36 percent local (Mexican) content quota required under the 1989 auto decree as long as they fulfilled NAFTA's rule of origin---a clear bias in favour of incumbents and in particular the Big Three.

The effect of rules of origin on outsiders was by no means unexpected. In a 1991 report to Congress, the USITC clearly cited the implications for foreign producers based in Mexico, especially automotive and electronics firms, as well as their concerns about the possible discriminatory effect of an FTA.[51] The same report noted that because of the small size of the

---

[46] In 1992, US Customs had ruled that Honda Civics assembled in Ontario between January 1989 and March 1990 did not fulfill the origin requirement of the CUSFTA, set at 50%. New York Times, 17 June 1991.
[47] Cameron and Tomlin, *The Making of Nafta*, 92.
[48] Frederick Mayer, *Interpreting Nafta: The Science and Art of Political Analysis* (New York: Columbia University Press, 1998), 121.
[49] Ibid.; United States International Trade Commission, Rules of Origin Issues Related to Nafta and the North American Automotive Industry: Report to the Committee on Ways and Means, U.S. House of Representatives, on Investigation No. 332-314 under Section 332 of the Tariff Act of 1930, Usitc Publication ; 2460 (Washington, DC: U.S. International Trade Commission, 1991)., The Globe and Mail, 12 October 1991.
[50] Maryse Robert, *Negotiating Nafta: Explaining the Outcome in Culture, Textiles, Autos, and Pharmaceuticals* (Toronto: University of Toronto Press, 2000), 161, 194.; "U.S. Automakers Press for Preferences During 15-Year NAFTA Transition," *Inside U.S. Trade*, 23 September 1991.
[51] United States International Trade Commission, *The Likely Impact on the United States of a Free Trade Agreement with Mexico*, 4-19, 4-21, 4-26.

Mexican market, the trade creating effect of an FTA would be concentrated in intermediate goods serving US investment in Mexico.[52] A second USITC report pointed out that the investment liberalization clauses of NAFTA[53] enabled US automakers to wholly own parts suppliers in Mexico, which should further increase their competitiveness[54] vis-à-vis firms from third countries.

NAFTA also included the phasing out of the *maquiladora* benefits, as export-processing zones are redundant in a free trade agreement. The intended side effect was raising the costs for non-NAFTA producers. US firms had long criticized that Japanese investors in the *maquiladoras* imported most of their parts from Japan rather than sourcing them from the US or Mexican suppliers.[55] NAFTA granted a temporary extension of duty-drawback programs (duty free entry of intermediate goods), but limited this to the lower of the two MFN tariffs.[56] Since the US tariff averages less than 4, the higher Mexican tariff effectively raised the cost of importing intermediate goods by 10-15 percent. In January 2001, the duty-drawback offered by Mexico was completely eliminated and the MFN tariff was levied by the US on goods that did not meet NAFTA's rule of origin requirements.

In contrast to regionally integrated industries, US industries that preferred to source globally opposed tight rules of origin. Most prominently, the computer industry procured most inputs from Asia and thus preferred free trade to regional integration.[57] IBM specifically opposed the inclusion of hard disks as a requirement for computers to qualify as North American,[58] since most hard disks were manufactured in Singapore. However, it did not oppose the requirement that cathode-ray tubes for monitors be produced in North America---Japanese firms assembled monitors in Mexico with imported cathode-ray tubes.[59] The outcome is selectively protectionist, requiring high North American content for some products, but not for others. The USITC states, "although the rules of origin are complex, they reportedly reflect the needs and desires of the domestic [US] industry."[60]

In sum, US firms had already begun to invest heavily in Mexico in reaction to its unilateral liberalization, building it up as an export platform to serve the US and third country markets. With specific clauses negotiated at the behest of economic interests, NAFTA secured these benefits exclusively for US firms and raised the barriers for outsiders. Much of the

---

[52] Ibid., 4-21, 4-25.

[53] NAFTA, Annex I, Reservations for Existing Measures and Liberalization Commitments, Schedule of Mexico, I-M-32.

[54] United States International Trade Commission, *Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement: Report to the Committee on Ways and Means of the United States House of Representatives and the Committee on Finance of the United States Senate on Investigation No. 332-337 under Section 332 of the Tariff Act of 1930*, *Usitc Publication ; 2596* (Washington, DC: U.S. International Trade Commission, 1993), 4-7.

[55] Gabriel Székely, "In Search of Globalization: Japanese Manufacturing in Mexico and the United States," in *Manufacturing across Borders and Oceans: Japan, the United States, and Mexico*, ed. Gabriel Székely (La Jolla, CA: Center for U.S.-Mexican Studies, University of California San Diego, 1991), 20..

[56] NAFTA, art. 303(2).

[57] Ronald J. Wonnacott, *The Nafta: Fortress North America?*, *Nafta Papers.* (Toronto: C.D. Howe Institute, 1993), 14.

[58] Cameron and Tomlin, *The Making of Nafta*, 90.

[59] Jon R. Johnson, *What Is a North American Good: The Nafta Rules of Origin*, ed. C.D. Howe Institute, *C.D. Howe Institute Commentary* (Toronto: C.D. Howe Institute, 1993), 12.

[60] United States International Trade Commission, Potential Impact on the U.S. Economy., 5-2, footnote 5.

agreement's added value lay in the non-tariff aspects of NAFTA in the fields of preferential investment liberalization, the abolishment of duty-drawback schemes, and high rules of origin.

The EU-Mexico FTA

When President Salinas traveled to Europe in early 1990 to advertise Mexico as an attractive investment location, he returned disheartened. European corporate and political leaders showed little interest in Mexico, being absorbed in the economic potential of Eastern Europe emerging from communist rule.[61] Yet in 1999, the EU concluded its first extra-regional FTA with Mexico. What had made Mexico so attractive?

A first factor was that Mexico retained and, in some tariff, categories even increased the margin between NAFTA and MFN trade barriers, largely by lifting the "applied" rate to the "bound" rate under the GATT, the maximum legally possible.

Table 2: Average tariff rate applied by Mexico

	1994	1995	1996	1997	1998	1999
Capital goods	11.7	11.7	11.5	11.4	11.4	14.5
Intermediate goods	11.4	11.8	11.3	11.2	11.2	13.9
Consumer goods	17.2	24.8	25.0	24.9	24.5	29.3
Total	12.4	13.7	13.3	13.3	13.2	16.1

(Source: Heinz Gert Preuße, Sechs Jahre Nordamerikanisches Freihandelsabkommen - Eine Bestandsaufnahme, Tübingen: Tübinger Diskussionsbeiträge No. 183, 2000).

With the conclusion of NAFTA, European firms with investment in Mexico, in particular in the automotive industry, were the first to be affected. Volkswagen was the first firm to feel increased pressure. In contrast to the US Big Three, Volkswagen's manufacturing and supply base was concentrated in Mexico's central region. VW had been an incumbent since 1964, when it had established a manufacturing plant in Puebla, 90km east of Mexico City. Between 1980 and 1991, VW de México dominated the domestic passenger car market with an average share of 30 percent.[62] In response to the 1977 auto decree, it built an engine plant and aluminium foundry, concentrating production on a single model (the beetle, or "vocho" in Mexican slang) and thus achieving higher domestic content than the US manufacturers. In 1981, VW began exporting engines to Germany, starting with about 15,000 units and reaching a peak of 340,000 in 1990. Still, the domestic production remained well below efficient scales for individual models,[63] motivating VW to invest US$ 1bn in the Puebla plant in 1991 and to produce Golf and Jetta models for the US market.

NAFTA's rules of origin posed a challenge to this strategy. While North American companies had access to their supply networks to fulfill the regional content quota, VW and Nissan did not. In 1992, VW acquired half of its inputs from Germany, 40 percent from Mexico and 10 percent from the US. However, this percentage differed considerably from model to

[61] Cameron and Tomlin, *The Making of Nafta*, 1-2.

[62] Asociación Mexicana de la Industria Automotriz, Balance De La Industria Automotriz (Mexico City: Asociación Mexicana de la Industria Automotriz, 1993).

[63] Womack estimates that a factory has to produce a minimum of 240,000 cars per year to be competitive. James P. Womack, "A Positive Sum Solution: Free Trade in the North American Motor Vehicle Sector," in *Strategic Sectors in Mexican-Us Free Trade*, ed. M. Delal Baer and Guy F. Erb (Washington, DC: Center for Strategic and International Studies, 1991).

model. Whereas the Old Beetle was 80 percent Mexican, the third generation Golf/Jetta was to be assembled of up to 90 percent imported parts. Despite the incumbent benefits granted to VW, fulfilling the rule of origin required an enormous strengthening of the local supply industry. While the decision to do so predated NAFTA, VW estimated that it would take ten years to develop adequate supply networks. At the same time, neither VW nor its European suppliers could invest in Mexico's parts industry without restrictions, since Mexico still maintained the 49 percent ownership ceiling for non-NAFTA firms. Volkswagen therefore faced the competition by the US Big Three with a burdensome inheritance of the pre-liberalization era, but with a much higher cost of restructuring.

The major decisions about restructuring the Mexican operations coincided with the NAFTA negotiations. Volkswagen initially opposed higher rules of origin, but then shifted its position, possibly because NAFTA granted differential phase-in periods for incumbent firms, including VW and Nissan, and new entrants. [64] However, following the 1994 Mexican peso crisis that depressed domestic demand, exports from Mexico to the US became all the more imperative, including exports of Jetta models back to Germany. VW therefore again shifted its position to be among the first to lobby for a compensatory arrangement.

Two other German automotive firms also looked at the Mexican market. BMW entered the market by setting up production facilities in Mexico in Toluca in 1994,[65] but only assembled of up to 10,000 vehicles. Mercedes Benz set up a manufacturing plant for large trucks in northern Mexico in Derramadero.[66] Consequently, the German Federation of Industries (BDI, Bund Deutscher Industrie), working on behalf of the German automobile industry, was among the strongest supporters of trade and investment liberalization.[67]

As a result of these developments, the European Commission warned in 1993 of the potential for "considerable trade diversion," since European companies would be largely excluded from the Mexican service sector if the Uruguay round failed to meet NAFTA standards.[68] While the integration of the US and the Mexican economy advanced quickly, the EU Commission came under pressure from lobbyists to counter NAFTA's effects. A 1995 survey by the Delegation of the European Commission in Mexico found that European companies in fields such as telecommunications, automobiles, chemical, pharmaceuticals and footwear felt severely disadvantaged by NAFTA.[69] Between 1995 and 1997, Spain, Belgium France, Italy, the UK and Germany[70] negotiated bilateral investment treaties with Mexico to establish a minimum of legal guarantees equal to NAFTA Chapter 11, but without equivalent liberalization of Mexico's investment regime. However, the Mexican offer of signing an actual FTA was rebuffed by the

---

[64] Cameron and Tomlin, *The Making of Nafta*, 134-135.
[65] http://automotriz.mural.com/autos/articulo/003043/; http://www.amia.com.mx/edomex.htm; http://www.bmw.com.co/cog/fascinacion/Tradicion/story/caminoexito.htm
[66] Moreno Brid, "Mexico's Auto Industry after Nafta."
[67] International Herald Tribune, 11 October 1997.
[68] "NAFTA welcomed by EC Commission amidst some concerns," Europe Information Service, Monthly report on Europe Newsletter, 24 June 1993.
[69] Delegation of the European Commission in Mexico, *Informe De Evolución De Las Relaciones UE-México* (Mexico City: 1995); José Antonio Sanahuja, "Trade, Politics, and Democratization: The 1997 Global Agreement between the European Union and Mexico," *Journal of Interamerican Studies and World Affairs* 42, no. 2 (2000): 60.
[70] While the EU Commission has the authority to negotiate trade agreements on the behalf of the member states, investment protection agreements remained in the domain of member states until the conclusion of the EU-Chile FTA.

Commission because of worries over agricultural imports.[71] The European Parliament's external economic relations committee (REX), by contrast, strongly supported the proposal at the behest of service industries.[72]

In May 1995, the European Commission, the Council and the Mexican government signed a Joint Solemn declaration to establish the foundations of a future "framework" agreement. However, EU member states differed in their commitment to negotiating an actual FTA with Mexico. At the Council meeting in February 1996, Spain and the United Kingdom supported the negotiation of a free trade agreement in a "single phase" undertaking, but were blocked by France because of fears of agricultural imports and the effect on trade with the ACP countries, many of which former French colonies.[73]

The Council finally reached a compromise in May 1996, deciding on gradual liberalization and negotiations on a sectoral basis.[74] The process was slowed down even further because services fell under member state jurisdiction and required unanimity in the Council, while trade in goods could be negotiated by the Commission with a qualified majority backing the mandate. Finally, on 11 June 1997, the EU and Mexico arrived at a framework agreement that established a joint council of Commission, member states and Mexico that would negotiate on bilateral trade and services liberalization, with the eventual aim of a fully-fledged FTA. This agreement was followed by acrimonious arguments in the council of permanent representatives of the member states (COREPER), in which France threatened to block the framework agreement because of the modification of the "democracy clause," a by now standard component of all EU trade agreements that called for adherence to democracy and the rule of law by the partners. Mexico reportedly saw the dispute as a thinly veiled attempt by the French representatives to prevent agricultural liberalization in a free trade agreement.[75] Talks towards a free trade agreement began on 14 July 1998.[76] The European side pushed particularly for rapid tariff and non-tariff elimination to compensate for the five-year advantage of US and Canadian firms.[77] Rules of origin for textiles, footwear and automobiles became a sticking point in the negotiations, because European firms feared exports by US companies manufacturing in Mexico, echoing arguments made earlier by US firms.[78] The agreement was finalized in November 1999.

The EU Commission cited as its achievements similar or better conditions for autmotive exports to Mexico than from the Canada and the US by reducing tariffs from 20 to 3.3 percent immediately and the complete elimination by 2003. EU firms would be granted at a minimum "NAFTA parity."[79]

---

[71] IPS-Inter Press Service/Global Information Network, 8 February 1995, "Mexico-Europe: EU sets out new strategy to retain markets."

[72] Europe Information Service, 14 November 1995, "EU/Mexico: MEPS put on their sombreros to support deeper relations with Mexico."

[73] "EU-Mexico: The European Council Sends the Conclusion of Accord with Mexico Back to the Permanent Representatives to Resolve Differences Regarding the Possibility of a Free Trade Zone," *European Information Bulletin*, 27 February 1996, 1. AP Press Business News, "Mexico Trade Talks Provoke Angry Dispute Among EU Nations," 26 February 1996; Europe Information Service European Report, "EU/Mexico: Further caution from EU Ministers," 28 February 1996.

[74] AP Press Business News, "EU Overcomes Hurdles To Free-Trade Talks With Mexico," 13 May 1996.

[75] Sanahuja, "Trade, Politics, and Democratization," 53.

[76] Financial Times, 15 July 1998.

[77] Financial Times, 9 March 1999.

[78] European Report, "EU/Mexico: EU intensifies pressure on liberalization of industrial goods," 26 June 1999 and "Seventh negotiating round with Mexico starts," 17 July 1999; Financial Times, 18 November 1999.

[79] Financial Times, 19 January 2000.

Within a few months of the conclusion of the FTA, European car manufacturers announced major investments in Mexico. Renault returned to Mexico after a 15-year absence with a joint production plant with Nissan, following the merger of the two car manufacturers in April 1999. Volkswagen earmarked US$1bn to the expansion of Mexican operations, which by then provided a third of the parts imports for its German factories and exported 300 New Beetle models daily to the EU. Peugeot executives visited Mexico in January to survey sites for future investments.[80] Daimler Chrysler unveiled plans to invest US$ 2bn over five years in Mexico.[81]

The effects of NAFTA on European FDI in Mexico triggered a countermove by the EU, leading to the first expansion of its free trade network across the Atlantic. Yet the EU strategy had an unexpected consequence in itself: it led trade policymakers in Japan to reconsiders the country's exclusive focus on the multilateral trade regime.

The Japan-Mexico FTA

While the Japan-Mexico FTA is of limited importance in terms of the actual trade flows between the two countries, it signifies a major step for Japanese trade policy. For over four decades, Japan relied exclusively on the multilateral trade regime, making it a "hard test" for the theory outlined here. The Japan-Mexico FTA represents the first substantive agreement that covers agricultural products.[82] NAFTA thus triggered a major shift, highly contested domestically, in Japan's foreign economic policy, underscoring the strength of the causal mechanism.

Japanese investment in Mexico is small compared to that from the US and the EU. However, it is heavily concentrated in the *maquiladoras*: Sectorally in consumer electronics and auto parts in which Japanese manufacturers have a traditional competitive advantage; geographically in Baja California and the northeast of Mexico.[83] Japanese firms used their US subsidiaries to set up production facilities in Mexico, thus benefiting from the Mexican duty drawbacks and the limited-duty imports under the US tariff classes 806 and 807. Mainly aimed at the US market, *maquiladora* plants also began to export to regional markets.[84] In 1990, Japanese investment in the *maquiladoras* represented 6 percent of the total number of plants, with about 25,000 employees, of which 55 percent produced electronics parts, while most automotive parts firms produced wire harnesses.[85]

NAFTA's high rules of origin and the phasing out of duty-drawback schemes presented Japanese investors with a severe problem. Instead of paying zero tariff for imported intermediate goods destined to be re-exported, Japanese firms would face the 10 to 15 percent MFN tariff from 2001 on.[86] Electronics manufacturers located to Mexico to cut shipping times to markets,

[80] Financial Times, 5 January 2000.
[81] Financial Times, 24 May 2000.
[82] Japan's first FTA with Singapore was easier to negotiate because the city-state does not export agricultural goods. Still, the negotiations were temporarily blocked because of
[83] Leslie S. Hiraoka, *Global Alliances in the Motor Vehicle Industry* (Westport, CT: Quorum Books, 2001), 120.
[84] Nikkan Sangyō Shimbun, 31 July 1991.
[85] Akihiro Koido, "The Color Television Industry: Japanese-U.S. Competition and Mexico's Maquiladoras," in *Manufacturing across Borders and Oceans: Japan, the United States, and Mexico*, ed. Gabriel Székely (La Jolla, CA: Center for U.S.-Mexican Studies, University of California San Diego, 1991).
[86] United States Trade Representative, "National Trade Report on Foreign Trade Barriers," (Washington, DC: USTR, 2000).

but they still imported most machinery for production from Japan.[87] Cathode tubes for TV sets mentioned before would now carry a 16 percent duty.[88] Especially electronics firms such as Hitachi and Kenwood shifted production and sourcing from Asia to Mexico in response to NAFTA, although this frequently entailed higher costs.[89]

Nissan, as the only Japanese car manufacturer located in Mexico, initially saw no problems in fulfilling the regional content requirements, given its presence in Mexico since 1962.[90] However, the liberalization measures and the impending competitive pressures forced it to reorient part of its production to exports to the US market.[91] The incumbency benefits of NAFTA therefore lost their lustre, moving the company's position closer to that of other Japanese firms. After the merger with Renault in 1999, Nissan planned to use Mexico as a production base even more extensively.[92] Honda announced in 1994 that it would start producing cars in Mexico. Toyota began talks with Mexican officials about the same time,[93] but did not announce the set-up of production facilities until 2002, when it opened a plant in Tijuana to produce SUVs for the North American market. Major parts producers such as Denso followed their most important buyer, setting up shop nearby.[94] At the same time, they voiced their concerns over NAFTA through various quasi-governmental publication channels.[95] Supplier of parts and machinery disapproved of high duties on imports into Mexico.[96]

The immediate solution to the higher cost burden of Japanese firms would have been tariff reduction by Mexico. In September 1992, Japanese trade minister Watanabe asked his Mexican counterpart Noyola to offer tariff relief on parts.[97] Japanese firms organized in the Japan Maquiladora Association lobbied the Mexican government directly for tariff reductions, [98] since NAFTA manufacturers would be unable to supplant their Japanese counterparts within a time frame of ten years. The Japanese Chamber of Commerce in Mexico likewise engaged in lobbying efforts.[99]

In response, the Mexican Secretariat of Commerce and Industrial Development (SECOFI) promised a sectoral promotion programme that offered selective tariff reductions (PROSEC). However, it proved to be burdensome for individual firms and unpredictable in its

---

[87] Nihon Keizai Shimbun, 15 December 1998. David W. Edgington and W. Mark Fruin, "Nafta and Japanese Investment," in *Foreign Investment and Nafta*, ed. Alan M. Rugman (Columbia, SC: University of South Carolina Press, 1994), 253-275.
[88] Nihon Keizai Shimbun, 12 December 2002.
[89] Nihon Keizai Shimbun, 5 January 1996.
[90] Nihon Sangyō Shimbun, 30 July 1991.
[91] Nikkei Business, 29 November 1993.
[92] Nikkan Sangyō Shimbun, 7 June 2001.
[93] Moreno Brid, "Mexico's Auto Industry after Nafta."
[94] Nikkan Sangyō Shimbun, 23 September 2002.
[95] Japan Institute for Overseas Investment, "Tokushuu Mekishiko No Toushi Joukyou: Joi Chousa Kekka Houkou: Nikkei Sangyou Shinshutsu Joukyou Oyobi Toushi Kankyou Houka (Special on the Mexican Investment Environment: Report on the Findings of Japanese Institute for Overseas Investment Study: The Current Situation and Investment Environment of Japanese Entreprises)," *Kaigai Yuushi* 6, no. 4 (1997): 13.
[96] Ibid.: 64.
[97] Japan Economic Newswire, "Japan Asks Mexico to Ease Burdens on NAFTA Outsiders," 29 September 1992.
[98] Nihon Keizai Shimbun, 5 January 1996.
[99] Eileen Byrne, "A Redefined Role in Mexico under NAFTA: Keeping Japan Interested," *Business Mexico*, March 1994.

application.[100] In fact, the Mexican may have deliberately held out to gain leverage in future negotiations with Japan. On three occasions in 1998 and 1999, President Zedillo and Trade Minister Blanco spoke about the impending changes in the maquiladora system before Japanese business audiences, while mentioning the benefits of FTAs.[101]

Lobbying in Japan also put the government under pressure. Already in a 1991 interview, the regional managers of several Japanese firms in Mexico referred to NAFTA as an "assault on Japanese firms."[102] A Japanese government panel at the Economic Planning Agency (EPA) criticized NAFTA's rules of origin in August 1993.[103] Shortly after NAFTA's passage by the US Congress in November, executives of Hitachi and Nissan expressed worry about its discriminatory nature.[104] The Japanese Federation of Industries (Keidanren) commented negatively on NAFTA's GATT review in 1994. In 1997, the Japanese Institute for Overseas Investment cited the high cost of importing machinery into Mexico from Japan as problem for Mexico's investment climate.[105]

The conclusion of the EU-Mexico framework agreement in 1997 finally convinced JETRO Chairman and former MITI (Ministry of International Trade and Industry) Vice-Minister Hatakeyama that Japan could only counter with its own FTA.[106] MITI Minister Yosano charged the International Trade Policy Bureau with estimating the economic effects of such a policy. Parallel efforts were undertaken at the Economic Affairs Bureau at the Ministry of Foreign Affairs (MOFA) under Director General Tanaka. However, unlike MITI with its close contacts to Japanese multinational firms with considerable overseas investment, MOFA was more concerned about balancing the interests of more protectionist ministries, as well as the implications for Japanese foreign policy in general.[107] MITI's *White Papers on Foreign Trade* began over time to reflect the changes in attitudes towards FTAs, from carefully positive to fully supportive of. In comparison, the MOFA *Diplomatic Blue Books* are more cautious and trail the METI Papers by a year in their positive assessments.[108]

In overcoming domestic resistance, in particular the agricultural lobby, the two ministries relied on the support of Japanese industry associations. Keidanren issued several policy papers calling for the rapid conclusion of a free trade agreement to counter NAFTA's effects. The association stressed the need to be able to import components, machinery, and chemical products from Japan to shorten lead times in starting up production in Mexico. Its joint business council with Mexican executives led efforts on both sides of the Pacific.[109] Following the Japan-

---

[100] Japan Machinery Center for Trade and Investment (JMCTI), "Prosec Ni Kan Suru Youbousho Wo Mekishiko Keizai Daiji Ni Tei (Proposal for the Requests Regarding Prosec to the Mexican Minister of the Economy)," *JMC Journal* 49, no. 4 (2001): 5-6.
[101] Nihon Keizai Shimbun, 15 September 1998, 7 October 1998, 2 March 1999.
[102] Nikkan Sangyō Shimbun, 30 July 1991.
[103] Japan Economic Newswire, "NAFTA partly against GATT rules, gov't panel notes," 4 August 1993.
[104] Japan Economic Newswire, "NAFTA passage draws mixed reaction from Japan's business," 18 November 1993.
[105] Japanese Institute for Overseas Investment, "Special on the Mexican Investment Environment"
[106] Noboru Hatakeyama, "Short History of Japan's Movement to Ftas (Part 1)," *Journal of Japanese Trade and Industry* 21, no. 6 (2003).; Interview with former senior MITI official, Tokyo, November 2002.
[107] Interview with MOFA official, Tokyo, March 2003.
[108] Tatsushi Ogita, "An Approach Towards Japan's Fta Policy," (Chiba: APEC Study Center, JETRO Institute of Developing Economies, 2002).
[109] Working Group on Japan-Mexico Bilateral Treaties, Japan-Mexico Economic Committee, Keidanren: Report on the Possible Effects of a Japan-Mexico Free Trade Agreement on Japanese Industry, April 20, 1999. http://www.keidanren.or.jp/english/policy/pol099.htm. See also http://www.keidanren.or.jp/japanese/policy/2000/016.html.

Singapore FTA, business leaders intensified their lobbying efforts.[110] However, the negotiations collapsed in October 2003, when the Japanese side refused to open its agricultural market for critical exports like pork and orange juice. Remaining differences could finally be ironed out during meetings in early March 2004.[111] Japan offered only moderate liberalization of its agricultural market. This underlines that for both sides, direct investment and industrial goods exports were central to the agreement. Bilateral FTAs tend to avoid the liberalization of sensitive sectors, indicating that disagreement at the WTO over the same sectors cannot be their driving force.

Conclusions: Towards More North-South-FTAs

As the case studies show, the proliferation of regional trade agreements between developed and developing countries is driven by an endogenous, competitive dynamic. This dynamic unfolds with the rapid expansion of FDI from the developed to the developing world. Multinational firms seek to internalize the benefits of location by investing in emerging market countries. Rather than simply competing in liberalized markets, these firms lobby governments to shape regional trade agreements to their exclusive benefit. Instead of supporting free trade, preferential trade agreements become a vehicle for protectionism.

FDI today implies a rapid increase in trade, because operations are integrated globally rather than split between protected domestic markets. Both factors exacerbate the discriminatory nature of bilateral trade agreements, forcing countries to follow suit and secure their multinational firms' competitiveness with more bilateral deals.

In addition to the cases analyzed here, the account offers insights into the driving forces of a growing number of cases: Japanese FTAs with Southeast Asian and South American countries, the EU initiative for an FTA with the ASEAN countries, as well as the various bilateral initiatives of the US. Moreover, with qualifications it can be usefully extended to cover initiatives between developing countries where foreign direct investment flows predominantly in one direction, such as Korea-Mexico.

On a theoretical level, the explanation put forth in this paper does not endeavor to capture all of the forces at work in the negotiation of preferential trade agreements. FTAs can also be used to express political support when strategic interests are at stake, as in the case of the US-Jordan FTA and the follow-up initiative to establish a regional free trade zone in the Middle East. Likewise, in cases of FTAs between countries of highly similar levels of development, other considerations such as achieving economies of scale will be of central importance, while investment tends to flow in both directions. Yet, the rapidly growing number of North-South-FTAs makes them one of the most important developments in the global trade regime.

[110] Asahi Shimbun, 13 February 2001.
[111] Nihon Keizai Shimbun, 9 March 2004.

Bibliography

Asociación Mexicana de la Industria Automotriz, *Balance De La Industria Automotriz* (Mexico City: Asociación Mexicana de la Industria Automotriz, 1993).

David P. Baron, "Integrated Market and Nonmarket Strategies in Client and Interest Group Politics," **Business and Politics**, Vol. 1, No. 1 (1999), pp. 7-34.

Stephen Blank, and Jerry Haar, *Making Nafta Work: U.S. Firms and the New North American Business Environment* (Miami, FL: North-South Center Press, 1998).

Houssein Boumellassa, Yvan Decreux, and Lionel Fontagné, *Economic Impact of a Potential Free Trade Agreement (Fta) between the European Union and Asean*, 2006 (Paris: CEPII-CIREM).

Tim Büthe, "Taking Temporality Seriously: Modeling History and the Use of Narratives as Evidence," **American Political Science Review**, Vol. 96, No. 3 (2002), pp. 481-493.

Tim Büthe, and Helen V. Milner, "The Politics of Foreign Direct Investment into Developing Countries: Increasing Fdi through Policy Commitment Via Trade Agreements and Investment Treaties," Paper presented at the Annual Meeting of the American Political Science Association, Chicago, IL, 2-5 September 2004.

Maxwell A. Cameron, "North American Trade Negotiations: Liberalization Games between Asymmetric Players," **European Journal of International Relations**, Vol. 3, No. 1 (1997), pp. 105-139.

Maxwell A. Cameron, and Brian W. Tomlin, *The Making of Nafta: How the Deal Was Done* (Ithaca, NY: Cornell University Press, 2000).

Kerry A. Chase, "Economic Interests and Regional Trading Arrangements: The Case of Nafta," **International Organization**, Vol. 57, No. 1 (2003), pp. 137-174.

———, "Protecting Free Trade: The Political Economy of Rules of Origin," **International Organization**, Vol. 62, No. 3 (forthcoming).

Commission of the European Communities, *Global Europe: Competing in the World*, 2006 (Brussels: Commission of the European Communities).

Jo-Ann Crawford, and Roberto V. Fiorentino, *The Changing Landscape of Regional Trade Agreements*, 2005 (Geneva: WTO Secretariat).

Francesca Di Mauro, *The Impact of Economic Integration on Fdi and Exports: A Gravity Approach*, 2000 (Brussels: Centre for European Policy Studies).

David W. Edgington, and W. Mark Fruin, "Nafta and Japanese Investment," in Alan M. Rugman, ed., *Foreign Investment and Nafta* (Columbia, SC: University of South Carolina Press, 1994) pp. 253-275.

Antoni Estevadeordal, and Kati Suominen, "Rules of Origin: A World Map," Paper presented at the Pacific Economic Cooperation Council (PECC) and the Latin America/Caribbean and Asia/Pacific Economic and Business Association (LAEBA) Seminar on "Regional Trade Agreements in Comparative Perspective: Latin America and the Caribbean and Asia-Pacific", Washington, DC, 22-23 April 2003.

Raquel Fernández, and Jonathan Portes, "Returns to Regionalism: An Analysis of Nontraditional Gains from Regional Trade Agreements," **World Bank Economic Review**, Vol. 12, No. 2 (1998), pp. 197-220.

Roberto V. Fiorentino, Luis Verdeja, and Christelle Toqueboeuf, *The Changing Landscape of Regional Trade Agreements: 2006 Update*, 2006 (Geneva: WTO Secretariat, Regional Trade Agreements Section, Trade Policies Review Division).

Alexander L. George, "Case Studies and Theory Development: The Method of Structured, Focused Comparison," in Paul Gordon Lauren, ed., *Diplomacy: New Approaches in History, Theory, and Policy* (New York: Free Press, 1979) pp. 43-68.

Alexander L. George, and Timothy J. McKeown, "Case Studies and Theories of Organizational Decision Making," **Advances in Information Processing in Organizations**, Vol. 2 (1985), pp. 21-58.

Edward M. Graham, and Erika Wada, "Domestic Reform, Trade and Investment Liberalisation, Financial Crisis, and Foreign Direct Investment into Mexico," **World Economy**, Vol. 23, No. 6 (2000), pp. 777-797.

Stephan Haggard, "Regionalism in Asia and the Americas," in Edward D. Mansfield and Helen V. Milner, eds., *The Political Economy of Regionalism* (New York: Columbia University Press, 1997) pp. 20-49.

Noboru Hatakeyama, "Short History of Japan's Movement to Ftas (Part 1)," **Journal of Japanese Trade and Industry**, Vol. 21, No. 6 (2003), pp. 24-25.

Leslie S. Hiraoka, *Global Alliances in the Motor Vehicle Industry* (Westport, CT: Quorum Books, 2001).

Japan Institute for Overseas Investment, "Tokushuu Mekishiko No Toushi Joukyou: Joi Chousa Kekka Houkou: Nikkei Sangyou Shinshutsu Joukyou Oyobi Toushi Kankyou Houka (Special on the Mexican Investment Environment: Report on the Findings of Japanese Institute for Overseas Investment Study: The Current Situation and Investment Environment of Japanese Entreprises)," **Kaigai Yuushi**, Vol. 6, No. 4 (1997), pp. 8-18.

Japan Machinery Center for Trade and Investment (JMCTI), "Prosec Ni Kan Suru Youbousho Wo Mekishiko Keizai Daiji Ni Tei (Proposal for the Requests Regarding Prosec to the Mexican Minister of the Economy)," **JMC Journal**, Vol. 49, No. 4 (2001), pp. 5-6.

Jeri Jensen-Moran, "Choice at the Crossroads: Regionalism and Rules of Origin," **Law and Policy in International Business**, Vol. 27, No. 4 (1996), pp. 981-989.

Jon R. Johnson, *What Is a North American Good: The Nafta Rules of Origin* (Toronto: C.D. Howe Institute, 1993).

Gary King, Robert O. Keohane, and Sidney Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research* (Princeton, NJ: Princeton University Press, 1994).

Akihiro Koido, "The Color Television Industry: Japanese-U.S. Competition and Mexico's Maquiladoras," in Gabriel Székely, ed., *Manufacturing across Borders and Oceans: Japan, the United States, and Mexico* (La Jolla, CA: Center for U.S.-Mexican Studies, University of California San Diego, 1991) pp. 51-75.

Kala Krishna, and Anne O. Krueger, "Implementing Free Trade Areas: Rules of Origin and Hidden Protection," in Alan Deardorff, James Levinsohn and Robert Stern, eds., *New Directions in Trade Theory* (Ann Arbor: University of Michigan Press, 1995) pp. 149-187.

Anne O. Krueger, "Are Preferential Trading Arrangements Trade-Liberalizing or Protectionist?," **Journal of Economic Perspectives**, Vol. 13, No. 4 (1999), pp. 105-124.

———, *Free Trade Agreements as Protectionist Devices: Rules of Origin*, 1993 (Cambridge, MA: NBER).

———, *Trade Creation and Trade Diversion under Nafta*, 1999 (Cambridge, MA: National Bureau of Economic Research).

Paul R Krugman, "Regionalism Versus Multilateralism: Analytical Notes," in Jaime De Melo and Arvind Panagariya, eds., *New Dimensions in Regional Integration* (Cambridge, UK: Cambridge University Press, 1993).

Eduardo Levy Yeyati, Ernesto H. Stein, and Christian Daude, *Regional Integration and the Location of Fdi*, 2003 (Washington, DC: IADB).

Edward D. Mansfield, and Eric Reinhardt, "Multilateral Determinants of Regionalism: The Effects of Gatt/Wto on the Formation of Preferential Trading Arrangements," **International Organization**, Vol. 57, No. 4 (2003), pp. 829-862.

Clara Patricia Martín, and Juan Mauricio Ramírez, *Impacto Económico De Un Acuerdo Parcial De Libre Comercio Entre Colombia Y Los Estados Unidos*, 2005 (Bogotá: Oficina de la CEPAL en Bogotá).

Frederick Mayer, *Interpreting Nafta: The Science and Art of Political Analysis* (New York: Columbia University Press, 1998).

Helen V. Milner, *Resisting Protectionism: Global Industries and the Politics of International Trade* (Princeton, NJ: Princeton University Press, 1988).

Juan C. Moreno Brid, *Mexico's Auto Industry after Nafta: A Successful Experience in Restructuring?*, 1996 (Notre Dame, IN: Kellogg Institute of International Studies, University of Notre Dame).

Aurelia George Mulgan, "Where Tradition Meets Change: Japan's Agricultural Politics in Transition," **Journal of Japanese Studies**, Vol. 31, No. 2 (2005), pp. 261-298.

Tatsushi Ogita, *An Approach Towards Japan's Fta Policy*, 2002 (Chiba: APEC Study Center, JETRO Institute of Developing Economies).

T. Ozawa, "The Southerly Spread of America's Automobile Industry. Flexible Production and Foreign Direct Investment as a Corporate Restructuring Agent," **World Competition**, Vol. 17, No. 4 (1994).

Manuel Pastor, and Carol Wise, "The Origins and Sustainability of Mexico Free-Trade Policy," **International Organization**, Vol. 48, No. 3 (1994), pp. 459-489.

Maryse Robert, *Negotiating Nafta: Explaining the Outcome in Culture, Textiles, Autos, and Pharmaceuticals* (Toronto: University of Toronto Press, 2000).

Razeen Sally, "Thai Trade Policy: From Non-Discriminatory Liberalisation to Ftas," **The World Economy**, Vol. 30, No. 10 (2007), pp. 1594-1620.

José Antonio Sanahuja, "Trade, Politics, and Democratization: The 1997 Global Agreement between the European Union and Mexico," **Journal of Interamerican Studies and World Affairs**, Vol. 42, No. 2 (2000), pp. 35-64.

Kenneth C. Shadlen, "Exchanging Development for Market Access? Deep Integration and Industrial Policy under Multilateral and Regional-Bilateral Trade Agreements," **Review of International Political Economy**, Vol. 12, No. 5 (2005), pp. 750-775.

Mireya Solís, and Saori N. Katada, "Competitive Regionalism: Strategic Dynamics of Fta Negotiation in Japanese Trade Diplomacy," *Annual Convention of the International Studies Association* (Chicago, IL: 2007).

Gabriel Székely, "In Search of Globalization: Japanese Manufacturing in Mexico and the United States," in Gabriel Székely, ed., *Manufacturing across Borders and Oceans: Japan, the United States, and Mexico* (La Jolla, CA: Center for U.S.-Mexican Studies, University of California San Diego, 1991) pp. 1-24.

Marcela Szymanski, and Michael E. Smith, "Coherence and Conditionality in European Foreign Policy: Negotiating the Eu-Mexico Global Agreements," **Journal of Common Market Studies**, Vol. 43, No. 1 (2005), pp. 171-192.

United States International Trade Commission, *The Likely Impact on the United States of a Free Trade Agreement with Mexico* (Washington, DC: United States International Trade Commission, 1991).

———, *Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement: Report to the Committee on Ways and Means of the United States House of Representatives and the Committee on Finance of the United States Senate on Investigation No. 332-337 under Section 332 of the Tariff Act of 1930* (Washington, DC: U.S. International Trade Commission, 1993).

———, *Rules of Origin Issues Related to Nafta and the North American Automotive Industry: Report to the Committee on Ways and Means, U.S. House of Representatives, on Investigation No. 332-314 under Section 332 of the Tariff Act of 1930* (Washington, DC: U.S. International Trade Commission, 1991).

United States Trade Representative, *National Trade Report on Foreign Trade Barriers*, 2000 (Washington, DC: USTR).

James P. Womack, "A Positive Sum Solution: Free Trade in the North American Motor Vehicle Sector," in M. Delal Baer and Guy F. Erb, eds., *Strategic Sectors in Mexican-Us Free Trade* (Washington, DC: Center for Strategic and International Studies, 1991) pp. 31-65.

Ronald J. Wonnacott, *The Nafta: Fortress North America?* (Toronto: C.D. Howe Institute, 1993).

Hidetaka Yoshimatsu, "Preferences, Interests, and Regional Integration: The Development of the Asean Industrial Cooperation Arrangement," **Review of International Political Economy**, Vol. 9, No. 1 (2002), pp. 123-149.